Monthly Briefing
World Economic Situation and Prospects

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This special issue covers the highlights of the *World Economic Situation and Prospects 2011*, launched on 18 January 2011

Summary

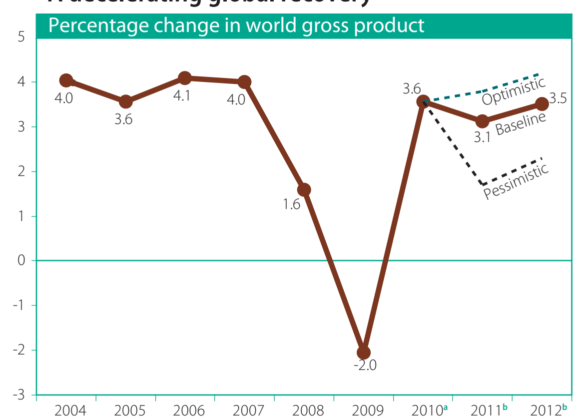
- A further slowdown in global economic growth is expected
- Developing economies continue to lead the recovery
- There are major downside risks for a gloomier outlook, including too early moves to fiscal austerity, further exchange rate volatility and a renewed widening of the global imbalances

Global outlook

Uneven global economic growth

After a year of fragile and uneven recovery, global economic growth started to decelerate on a broad front in mid-2010 and this slowdown is expected to continue into 2011 and 2012. The United Nations baseline forecast for the growth of world gross product (WGP) is 3.1 per cent for 2011 and 3.5 per cent for 2012, which is below the 3.6 per cent estimated for 2010 and the pre-crisis pace of global growth (see figure 1).

Figure 1:
A decelerating global recovery



Source: UN/DESA, *World Economic Situation and Prospects 2011*.
a Partly estimated.
b United Nations forecasts.

Weaknesses in major developed economies continue to drag the global recovery and pose risks for world economic stability in the coming years. The unprecedented scale of the policy measures taken by Governments during the early stage of the crisis has no doubt helped stabilize financial markets and jump-start a recovery, but overcoming the structural problems that led to the crisis and those that were created by it is proving much more challenging and will be a lengthy process:

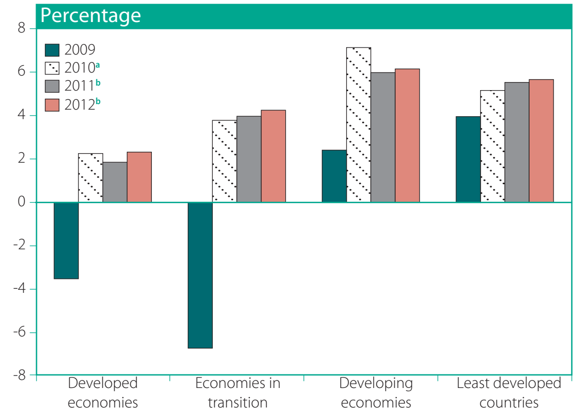
Despite the notable progress made by the banking sector in disposing of its troubled assets, many of the banks in major developed countries remain vulnerable to multiple risks. Those financial risks include a further deterioration in real estate markets, more distress in sovereign debt markets, and continued low credit growth associated with overall economic weakness and the ongoing deleveraging among firms and households.

Persistent high levels of unemployment, with increasing numbers of workers that have been without a job for prolonged periods, are restraining private consumption demand; they are also a continued cause of increasing housing foreclosures, which are adding to the fragility of the financial system.

Troubles with public finances have become daunting as well. Fiscal deficits have widened dramatically and have become a source of political contention. Deficits have increased, mainly as a consequence of the impact of the crisis on falling government revenues and rising social benefit payments. The costs of fiscal stimulus measures have compounded this situation but, contrary to popular belief, have contributed only in minor part to the increase in public indebtedness. Yet, rising public debt has engendered political and financial stress in a number of European countries and, more broadly, has undermined support for further fiscal stimuli. However, as Governments shift from fiscal stimulus to austerity, the recovery process is being placed in further jeopardy. The fiscal consolidation plans that have been announced so far by Governments of developed countries will impact negatively on gross domestic product (GDP) growth in the outlook for 2011 and 2012.

The woes of the advanced economies contrast with the strong GDP growth in many developing countries and economies in transition, which has been contributing to more than half of the expansion of the world economy since the third quarter of 2009 (see figure 2). The rebound has been led by the large emerging economies in Asia and Latin America, particularly China, India and Brazil. Many developing countries have been able to use the policy buffers (in the form of ample fiscal space and vast foreign-exchange reserves) they had generated in the years before the crisis to adopt aggressive stimulus packages. These have helped boost domestic demand and have thus facilitated a relatively quick recovery from the global downturn. Since the second quarter of 2009, low- and middle-income countries have also led the recovery of international trade, building on ties among developing countries through global value chains. Many smaller economies in Africa and Latin America have been able to benefit from these South-South linkages, as well as from more buoyant international primary commodity prices which have rebounded largely on account of the recovery in demand in the large developing economies. The return of private capital inflows to middle-income countries has further supported the recovery. By late 2010, developing country trade and industrial output had climbed to above pre-crisis levels.

Figure 2:
Developing country growth is leading the recovery



Source: UN/DESA, *World Economic Situation and Prospects 2011*.
a Partly estimated.
b United Nations forecasts.

It is uncertain, however, whether the developing countries and economies in transition can sustain the same robust pace of growth in 2011 and beyond. Despite strengthened trade ties amongst these countries, they remain highly dependent on demand in the developed countries for their exports. Access to capital flows and official development finance is also highly conditioned by financial circumstances and fiscal stances in advanced economies. A faltering recovery in those economies, on account of the abovementioned risks, should thus be expected to moderate growth prospects for developing economies as well. In addition, there are also important risks associated with the surge in private capital flows to emerging market economies. These flows are causing upward pressure on these countries' currencies and risk inflating domestic asset bubbles.

Protracted employment recovery

Between 2007 and the end of 2009, at least 30 million jobs were lost worldwide as a result of the global financial crisis. Despite a rebound in employment in parts of the world, especially in developing countries, the global economy will still need to create at least another 22 million new jobs in order to return to the pre-crisis level of global employment. At the current speed of the recovery, this would take at least five years.

Owing to the below-potential pace of output growth in the recovery, particularly in developed economies, few new jobs have been created to rehire those workers who have been laid off. As more Governments are embarking on fiscal tightening, the prospects for a quick recovery of employment look even gloomier. The longer term employment consequences of the present crisis are already becoming visible, as the share of the structurally or long-term unemployed has increased significantly in most developed countries since 2007.

Low inflation, except in Asia

The current rates of headline inflation have stayed at very low levels despite the massive monetary expansion. Except in some Asian economies, where increasingly strong inflationary pressures reflect a combination of supply and demand-side factors, inflationary expectations are likely to remain muted in the near future owing to the stagnation in credit growth, alongside wide output gaps and elevated unemployment in most developed economies.

Rebounding, but decelerating world trade

World trade continued to recover in 2010, but the momentum of the strong growth observed in the first half of the year has started to peter out. While the volume of exports of many emerging economies has already recovered to, or beyond, pre-crisis peaks, exports of developed economies have not yet seen a full recovery. In the outlook, world trade is expected to grow by about 6.5 per cent in both 2011 and 2012, moderating from the 10.5 per cent rebound in 2010.

Continued net financial transfers from poor to rich countries

Developing countries as a group continued to transfer vast amounts of financial resources to developed countries. In 2010, net transfers amounted to an estimated $557 billion, a slight increase from the level registered in the previous year. As has been the pattern for more than a decade, much of the net transfers reflect additional reserve accumulation by developing countries. In the outlook, net resource transfers from developing countries are expected to increase moderately along with the projected widening of current-account imbalances. This continuation of the pre-crisis pattern, in which, on balance, poor countries transfer significant amounts of resources to much richer nations, is also a reflection of the need felt by developing countries to continue to accumulate foreign-exchange reserves as a form of self-protection against global economic shocks. Instances of global financial market turbulence, increased exchange-rate volatility among major reserve currencies and a surge in short-term private capital flows have added to the sense of high macroeconomic uncertainty and the perceived need for self-insurance.

Downside risks

Key uncertainties and risks to the baseline scenario for 2011 and 2012 are slanted towards the downside.

Despite continued fragile recovery, the sense of urgency and the will to move fiscal and monetary policies in tandem dissipated during 2010 over worries, especially in developed countries, that fiscal sustainability could be in jeopardy. Such worries are juxtaposed to fears that the phasing-out of fiscal stimulus and a quick retreat into fiscal austerity would risk further deceleration of the recovery and fail to bring unemployment down, while public debt ratios would continue to rise because of insufficient output growth. Since budget deficits have widened sharply, public debt of developed countries will continue to increase, even under conservative assumptions, surpassing 100 per cent of GDP, on average, in the next few years.

The exchange rates among major currencies experienced high volatility during 2010, with escalated tension spreading rapidly to other currencies. The failure to maintain exchange rate stability among the three major international reserve currencies has also affected currencies of emerging economies. The surge in capital inflows to emerging economies, fuelled by the quantitative easing in developed countries and portfolio reallocation by international investors, as well as by the weakening of the dollar, has led to upward pressure on the exchange rates of some emerging economies. Currency instability and perceived misalignment of exchange rates could become part of a major skirmish over trade, which may well turn into a wave of protectionist measures and retaliations worldwide.

The global imbalances may widen again, which in turn could feed more instability back into financial markets. Prospects for narrowing the imbalances will depend on how successful economies will be in making structural adjustments. However, the path of these adjustments is unclear, particularly given the uncertainties about how the risks of a further slowing of growth and the persistence of high rates of unemployment, sovereign debt problems and further exchange-rate instability will all play out.

Policy challenges

The potentially damaging spillover effects of national policies once again highlight the need for strengthened international policy coordination. Unfortunately, during 2010, the cooperative spirit among policymakers in the major economies has been waning. *World Economic Situation and Prospects 2011* suggests that avoiding a double-dip recession and moving towards a more balanced and sustainable global recovery would require that at least five related major policy challenges be addressed.

First, by using the ample fiscal space that is still available in many countries, additional fiscal stimulus, in tandem with appropriate monetary policies, is needed in the short run to boost the global recovery. Such action should be adequately coordinated among the major economies to ensure a reinvigoration of global growth that will also provide external demand for those economies which have exhausted their fiscal space. Absent a new net fiscal stimulus and faster recovery of bank lending to the private sector, growth is likely to remain anaemic in many countries in the foreseeable future.

Second, fiscal policy needs to be redesigned to strengthen its impact on employment and aid in the transition towards promoting structural change for more sustainable economic growth. A prudent policy would be to target public investments with a view to alleviating infrastructure bottlenecks that mitigate growth prospects, addressing ecological challenges, for example regarding clean energy and climate change, and cushioning the social impact of economic shocks.

The third challenge is to find greater synergy between fiscal and monetary stimulus, while counteracting damaging international spillover effects in the form of increased currency tensions and volatile short-term capital flows. This will require reaching agreement about the magnitude, speed and timing of quantitative easing policies within a broader framework of targets to redress the global imbalances. It will also require deeper reforms of financial regulation, including those for managing cross-border capital flows, as well as in the global reserve system in order to reduce dependence on the United States dollar.

The fourth challenge is to ensure that sufficient resources are made available to developing countries, especially those possessing limited fiscal space and facing large development needs. These resources will be needed, in particular, to accelerate progress towards the achievement of the MDGs and for investments in sustainable and resilient growth. Apart from delivering on existing aid commitments, donor countries should consider mechanisms to delink aid flows from their business cycles so as to prevent delivery shortfalls in times of crisis, when the need for development aid is most urgent.

The fifth challenge is to find ways to arrive at credible and effective policy coordination among major economies. In this regard, there is some urgency in making the G20 framework for sustainable global rebalancing more specific and operational. In this context, establishing concrete “current-account target zones” might be a meaningful way forward. Having clear and verifiable targets for desired policy outcomes would help make parties accountable, while the possible loss of reputation through non-compliance would be an incentive to live up to policy agreements.

Regional outlook

Weakening recovery in developed countries

Among the developed economies, the *United States of America* has been on the mend from its longest and deepest recession since the Second World War. Yet, the pace of the recovery has been the weakest in the country's post-recession experience. At 2.6 per cent in 2010, growth is expected to moderate further to 2.2 per cent in 2011 and to improve slightly to 2.8 per cent in 2012. At these rates, the level of GDP will return to its pre-crisis peak by 2011, but a full recovery of employment would take at least another four years, leaving the level of output well below potential.

The growth prospects for *Europe* and *Japan* are even dimmer. Assuming continued, albeit moderate, recovery in Germany, GDP growth in the euro area is forecast to virtually stagnate at 1.3 per cent in 2011 and 1.7 per cent in 2012 (growth in 2010 was 1.6 per cent). Many European countries will see even less growth, especially those in which drastic fiscal cuts and continued high unemployment rates are draining domestic demand. This is especially the case in Greece, Ireland, Portugal and Spain, which are entrapped in sovereign debt distress and whose economies will either remain in recession or stagnate. Japan's initially strong rebound, fuelled by net export growth, started to falter in the course of 2010. Challenged by persistent deflation and elevated public debt, the economy is expected to grow by a meagre 1.1 per cent in 2011 and 1.4 per cent in 2012.

Fragile rebound in economies in transition

Among the economies in transition, the Commonwealth of Independent States *(CIS)* and *Georgia* experienced a rebound in GDP by about 4 per cent on average in 2010, up from the deep contraction of 6.7 per cent in 2009. Increased external demand and rebounding commodity prices are the drivers of the recovery. Domestic demand remains weak in most economies, especially in Ukraine. The recovery has slowed in the course of 2010, however. Output growth is not expected to accelerate in the outlook for 2011 and 2012. After a prolonged period of contraction, output growth in the economies in transition in *South-eastern Europe,* except for Croatia, returned to positive territory in 2010. In this case, too, export growth has been driving most of the recovery so far, while domestic consumption and investment demand remain subdued. In 2011 and 2012, the pace of recovery in South-eastern Europe is expected to be rather slow.

Strong growth in developing countries

Developing countries continue to drive the global recovery, but their output growth is also expected to moderate to 6.0 per cent on average during 2011-2012, down from 7.1 per cent in 2010. *Developing Asia*, led by China and India, continues to show the strongest growth performance, but GDP growth in these two new economic giants is expected to experience some moderation in 2011 and 2012. Growth in *Latin America*, particularly that in the South American economies, is projected to remain relatively robust at about 4.1 per cent in the baseline forecast. Yet, this implies a marked moderation from the 5.6 per cent GDP growth estimated for 2010. Brazil continues to act as the engine of regional growth, with strong domestic demand helping to boost the export growth of neighbouring countries. The subregion also benefits from improved terms of trade and strengthened economic ties with the emerging economies in Asia. The economic recovery in *Western Asia* is also expected to moderate from 5.5 per cent in 2010 to 4.7 per cent in 2011 and 4.4 per cent in 2012. At this pace, average annual output growth will be below the rates prevailing in the years before the crisis. The fuel-exporting economies of the region have not levelled oil production after the cutbacks made in response to the global recession. Economic recovery has been solid but below potential in most countries in *Africa*. In South Africa especially, the region's largest economy, output growth remains subpar as a result of, inter alia, weak manufacturing export growth. Elsewhere in the region, the economic recovery has been supported by the rebound in the demand for and prices of primary commodities as well as by increases in public investments in infrastructure, foreign direct investment (FDI) in extracting industries and improvements in conditions for agricultural production. In the outlook, the economic growth in the region is expected to remain somewhat below pre-crisis rates, averaging about 5.0 per cent for 2011-2012.

Below-potential perfomance of most least developed countries

On the other hand, formidable challenges remain in the long-run development of many low-income countries. Although average per capita income growth for these countries is expected to return to near pre-crisis rates in the outlook, it will not be sufficient to fully make up for the setbacks caused by the crisis. In particular, the recovery in many of the least developed countries (LDCs) will be below potential. Per capita income growth among LDCs is expected to reach about 3 per cent per annum during 2010 and 2011, which is well below the annual average of 5 per cent achieved during 2004-2007. The LDCs face diverging conditions. Bangladesh and the LDCs in East and Southern Africa are showing strong economic growth, while production in the Sahel, West Africa and parts of Asia is suffering either from adverse weather conditions or from fragile political and security situations, or both.